CANDRIAM
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2025 EMD Outlook: New Year, New Dynamics?

2025
Marketing Communication

New Year, New Dynamics?

The EM (emerging market) debt asset class enjoyed another stellar year in 2024, with hard currency sovereigns generating a total return of 6.54%. Spread returns of +6.69% more than compensated for the –0.14% drag from US Treasuries. Within EM sovereigns, it was the year of high yield (HY), with the segment posting +13.0% returns. The distressed debt segment continued to drive the bulk of the return, generating more than half of the returns of the EM sovereign asset class.

The story was similar for EM corporate debt markets, which generated a total return of +7.63% during 2024, due to a significant +5.54% contribution from spread return as spreads tightened by more than 60 bps during the year. The high yield sector of the EMD (EM debt) corporate universe significantly outperformed investment grade, with a +11.67% return for HY and a +4.93% return for IG (investment grade) Distressed credits were by far the best performers, with triple-Cs a significant contributor.

The new Trump administration in the US poses a potential source of volatility, with the likely resumption of tariffs and confrontational trade tactics. The EM hard currency market ended 2024 with both historically high yields and tight spreads. While the balance of risks remains notably uneven due to these rich spreads, the fundamentally sound picture across many EM countries and a very low expected default rate gives us reasons for optimism.[1]

1 - Figures relate to the JP Morgan EM Bond Index Global Diversified (EMBIG)

Fundamentals.

US Rates and the Dollar

The global macro environment will likely favour further dollar strength, despite the strong appreciation since the US elections in early November. Under President Trump's second administration, we may even test the dollar highs seen during Paul Volcker's Federal Reserve chairmanship in the 1980s.

The prospect of widespread and significant US tariffs weakens the outlook for global economic growth, especially in those EM markets which may be most impacted by Trump's trade policy changes. We expect a reduction of portfolio and direct investments into EM, and even more capital moving into dollar-denominated assets.

The continued strength of the US economy will likely leave the Fed somewhat more cautious in how quickly it is willing to ease monetary policy – and potentially further strengthen the dollar. The current growth trajectory, as well as the decent labour market data, which imply stickier inflation, support a view for this potentially slower decline in rates. The path depends heavily on Trump policies, such as promises of income tax cuts and deregulation, which could further boost the economy as well as inflation. If tariffs were to lead to increased prices of imports, this Trump promise could also generate higher inflation. These elements could lead in turn to a higher US terminal policy rate – possibly 3.75 or 4.00% -- resulting in a stronger dollar than was seen in the pre-Covid policy cycle. These higher interest rates make the US a relatively more attractive fixed income investment destination.

EM Interest Rates and Exchange Rates

Dollar strength is ultimately a headwind for EM currency performance. The most important pre-condition for the local currency asset class performance is for the Fed to meaningfully reduce the monetary policy rate – that is, to reduce it beyond current market expectations. We should only see this if the central bank is confident that inflation remains anchored around its target, quite an assumption in the complex risk landscape of geopolitics, higher tariffs, poor fiscal discipline in the US, and strong US growth. With 2025 almost sure to bring uncertainty on these issues, EM local currency investors will need to be nimble and to adjust their positions as the story develops. Idiosyncratic currency situations such as the Turkish lira, Egyptian pound, Nigerian naira or Dominican peso may prove valuable for investors in this environment.

The argument for buying EM rates is at least somewhat clearer, even if volatility continues. Foreign positioning in EM rates markets is low, real yields are high, and we think most central banks are likely to cut rates further, albeit gradually. We think markets such as Brazil, Colombia, the Czech Republic, and the Philippines offer attractive EM rates risk premia at present.

2 - Figures relate to the JP Morgan EM Corporate Bond Index (CEMBIG)

Rising Deficits

Fiscal indiscipline is arguably underappreciated by the markets, especially structural fiscal risks stemming from developed countries. Most importantly, the US is running an exceptionally large deficit, even more noteworthy given the current economic growth. If the second Trump administration follows through on promises of cutting income and other taxes, these actions should further increase the fiscal gap.

Admittedly, deregulation and a promised downsizing of the US government bureaucracy could partly offset the expected reduction in revenues, but in reality spending cuts are often harder to implement than tax cuts. The largest expenditures in the US budget – entitlements including Medicare, Medicaid, and Social Security, and the military budget – are difficult to reform, and especially so by only one side of the legislative aisle. Without cross-party consensus, any fallout from reform would disproportionately impact the party in power and thus we are unlikely to see the Republican election sweep translate into meaningful spending cuts.

US and global debt levels are likely to rise further, with the proportion of government revenues consumed by debt-service payments rising in tandem. While this may be relatively less problematic in periods of economic growth and easing monetary policy conditions, markets may be less willing to provide affordable financing to the US and other countries once another economic downturn hits.

Many EM economies face fiscal challenges, although there are exceptions and idiosyncrasies. Latin American sovereigns – such as Brazil, Mexico, and Colombia – are subject to some of the most intense market scrutiny for their loose and somewhat populist fiscal policies. Some sovereign issuers in this region are facing weaker currencies, higher local rates, and significant impacts on credit spreads. The recent sell-off in the Brazilian real and its local-currency government bonds is a good case in point, illustrating how unforgiving markets can be of sustained fiscal profligacy. The resulting inflation concerns have led the Brazilian central bank to raise policy rates, while most nations are easing monetary policy.

In Asia, we see relatively better fiscal discipline, though even here governments are occasionally caving to socio-political pressures for increased spending. In Europe, populist demands have resulted in some very worrying fiscal spending in countries such as Romania and Poland, but markets have given the benefit of the doubt to countries where political stability and reform appetite are stronger. On a positive note, South Africa’s National Treasury appears to have stabilized debt levels after many years of deterioration, while in Turkey a more orthodox economic policymaking team is now in charge --developments which have increased investor appetite for those credits.

Inflation

Apart from the possible impact of fiscal looseness and US tariffs, geopolitical pressures may also revive inflation. In addition, global central banks are still grappling with what appears to be somewhat sticky services inflation in many markets, while labour markets remain relatively strong, especially in the US.

The main deflationary impulse may emerge from China. If US tariffs are increased significantly, Chinese economic growth could struggle even further, and the impact may not be fully offset by China's economic stimulus program. This dynamic has important implications for emerging markets, as China accounts for a large share of global demand for metals and other commodities. EM commodity exporters are at risk of a slowdown, and so could 'import' some of China's lower inflation levels. For instance, this may impact copper exporters such as Chile and Zambia. Separately, lower Chinese exports to the US would likely result in a re-channelling of cheaper imports into other markets, especially those in nearby Asian countries. Europe – already struggling with weak economic growth – may also import some of China's deflationary dynamics.

The combination of these factors could result in an acceleration of the trends seen so far – subdued inflation for tradeable goods, but sticky inflation for services. This could present a dilemma for global central banks and could result in a higher potential for policy errors.

Commodities – China and Beyond

These vulnerabilities in the Chinese economy and their deflationary effects also make us cautious on oil prices as we enter 2025. The decline in Chinese oil imports in 2024 has already placed downward pressure on the global oil price, and we expect that this trend might continue or even accelerate. While transportation accounts for the largest share of oil demand, for the last several years the growth in demand has come mainly from petrochemicals – which could be affected by US tariffs. At the same time, deregulation and the clear intent of the Trump administration to encourage higher oil and gas investment will likely result in greater US supply, while OPEC+ is likely to have limited ability to accommodate further production cuts.

Disruptions in global trade could dent Chinese demand for industrial metals, where China is the main buyer. We expect further tariffs on Chinese steel and consumer products not only from the US, but other countries as well, pressuring Chinese manufacturing as well as global steel and copper prices.

Sustainability – Democracy and Water are both in Short Supply

A complex mix of geopolitical and environmental challenges which hung over 2024 will continue. While the US presidential election proceeded without the feared major disruptions, conflicts in the Middle East and Ukraine persisted.

With half of the world's population voting in 2024 elections, some governments are starting 2025 with new mandates and high expectations from their electorates. South Africa, for example, has benefitted from post-election improvements in the management of the electrical grid, and reduction of power outages and blackouts has translated into more optimism for the economic development of the country under the new coalition government.

As we noted in our Sovereign Sustainability white paper, water scarcity is fuelling protectionist policies and resource nationalism worldwide. This is evident in countries such as Mexico, where urbanisation, deforestation, and insufficient infrastructure have compounded water scarcity, pushing the government to consider export restrictions on water-intensive crops, including avocados and berries. Similarly, disputes over transboundary water resources, such as Ethiopia's GERD project on the Nile, underscore how water stress can escalate geopolitical tensions, impacting downstream nations like Egypt and Sudan.

Meanwhile, as the La Niña weather pattern takes hold, prolonged drought conditions in Sub-Saharan Africa and Latin America are exacerbating water challenges. In Zambia, droughts are straining food supply, driving inflation, and disrupting copper production. In Brazil and Chile, extended dry spells are affecting hydropower generation, a critical energy source for these economies, leading to energy shortages and higher costs. Elsewhere, power outages in South Africa and drought in India exacerbated the erosion of support for ruling majorities, and fuelling election surprises.

In Latin America, Ecuador's drought could potentially worsen with the resumption of La Niña, but electricity blackouts have eroded the popularity of current President Noboa in the runup to the general elections in February 2025 and are shaking the economic fundamentals of the country and investor sentiment. Attempts to start importing electricity from neighbouring Colombia have been met with resistance, as Colombia is battling drought as well. These dynamics reflect a broader shift towards "blue protectionism", where control over water and related resources becomes a key instrument of national policy. This shift has significant implications for global trade flows and supply chains, particularly in sectors heavily reliant on consistent water access, with electricity generation from hydropower in particular, given Latin America's outsize reliance on this resource and persistent climate-induced pressures on water availability.

The global environment is marked by challenges to democratic stability and governance, including unrest in South Korea and political uncertainty in Romania. In Korea, a brief imposition of martial law led to widespread civil unrest, exposing cracks in the country's democratic foundations. Romania's elections, plagued by procedural irregularities and allegations of foreign interference, have deepened political divisions,

raising concerns about the country's ability to maintain government stability. High public expectations, particularly in emerging markets, risk generating unrest if governments fail to deliver rapid economic and social improvements. The need for fiscal consolidation to maintain favourable external financing conditions will likely clash with growth slowdown and fatigue caused by the cost of living crises amongst the parts of the population most reliant on government support.

Compounding these pressures is the unpredictable global trade environment, including escalating trade tensions and the likely return of aggressive US trade policies under the Trump administration. Emerging markets, already grappling with various issues, could face further strain as trade wars disrupt supply chains and restrict access to critical goods. For resource-exporting nations such as Brazil, Chile, and Zambia, protectionist policies in key markets could further reduce demand for raw materials, weakening their ability to address domestic challenges. This combination of domestic and international pressures leaves many EM governments navigating a precarious balance between meeting public demands and responding to external shocks, with limited room for missteps.

Technicals.

Supply - Sovereigns

On balance, the supply technicals for the EM sovereign market are positive for 2025. We expect gross issuance to be slightly below 2024, but with increased debt servicing cashflows via coupons, and significantly higher amortizations, net financing should be much lower than that of 2024. Net financing needs for EM sovereigns is projected to be the lowest since 2015 (with the exception of 2022, when net financing was negative). This should be positive for the asset class, everything else being equal.

For comparison, the asset class saw increased issuance in 2024, versus the previous two years, on par with the $182.5 bn gross issuance of 2021. While 2024 amortizations were higher than for the previous two years, the net issuance and especially net financing needs (including debt servicing) in 2024 were greater than those of the prior previous years combined.[3]

We expect some HY issuers to return to the market in 2025, given marginally more attractive funding conditions, with tighter spreads and gradually falling interest rates in the US and Europe. Reliance on the IMF and multilateral financing should remain high, potentially rising, given that climate finance commitments are set to increase to $300 bn by 2030, as agreed at COP29. More countries are making use of debt-for-nature swaps, including El Salvador, the Bahamas, Barbados, and Ecuador. New deals are expected from Sri Lanka and Zambia, as well as from a number of other African countries.

We expect net supply to be positive for IG EM sovereigns, driven largely by Middle East issuance from Saudi Arabia, the UAE, and Israel, and to a lesser extent by Romania and Poland in CCE (Central and Eastern European Countries), as well as LatAm issuers such as Mexico and Colombia. In the HY EM sovereigns segment, Africa is likely to contribute negatively to net issuance, as a number of countries with market access issued in 2024, including South Africa, Kenya, and the Ivory Coast. Meanwhile, Hungary, Romania, and Poland have begun to issue samurai bonds in yen, reducing pressure on the dollar and euro curves.

3 - The JP Morgan EM Bond Index Global Diversified (EMBIG) and the JP Morgan EM Corporate Bond Index (CEMBIG).

Given the support that euro-denominated issuance receives from insurance and pension investors in Europe, as well as from crossover investors, both IG and HY credit spreads in USD are likely to remain supported from a technical perspective. Dispersion within the cohorts would be driven by idiosyncratic factors much more than by technical ones.

Given the expected fiscal consolidation in a number of countries, overall financing needs should be lower on balance, but with net financing needs in hard currency being quite small, the bulk of the issuance to cover fiscal deficits should be in local currency. This would also be cheaper for sovereigns in an environment of dollar strengthening, so technicals in local markets will be weaker on balance and will be weighed against the room that central banks will have to cut rates.

Supply - Corporate Issuance

We expect neutral to slightly positive net flows into the asset class in 2025, after a year of robust performance in 2024. We expect that the EMD flow picture will be stable into 2025, thanks to the quite strong performance of the asset class in 2024.

For 2024, the EMD asset class performance was broadly in line with US HY and EU HY debt, while the average rating for both EM benchmarks is investment grade. We also note that crossover holding in EM debt remains below its historical average.

We expect corporate issuance to be slightly higher in 2025, with higher amortizations and coupon payments. We look for the sizeable increase in debut issuers in 2024 to continue into 2025, leading to overall neutral or slightly positive net issuance.

Valuation and Fund Flows.

With the absolute yield levels still being attractive, we expect fund flows to stabilize in a more neutral territory in 2025.

Last year saw a slowing of the outflows that had begun in 2022 and continued through 2023. Through the end of November, actively-managed hard currency EM bond funds saw outflows of $15 bn, less than the $22 bn in 2023 and $38 bn in 2022. Hard currency ETFs saw small outflows, less than $1 bn in 2024. Local currency funds experienced $9.6 bn of outflows, with almost $3 bn from ETFs, comparable to the picture we saw in 2023.[4]

Overall and by segment, EM Sovereign spreads have tightened through a combination of resilient IG spreads and spread tightening in lower-rated buckets, with significant contributions from idiosyncratic developments in distressed credits. Despite being tight from a historical perspective, index-level spreads of EM sovereign credit look fairly valued when compared to US corporate credit. Moreover,

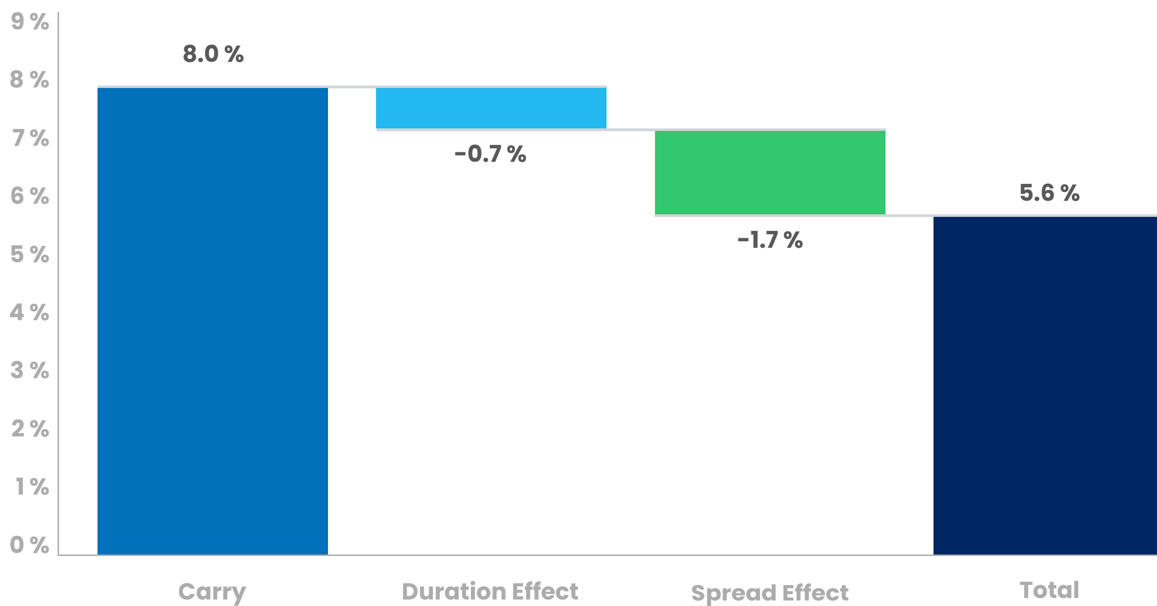
4 - JP Morgan 2 Dec 2024, 3 Jan 2025, Morgan Stanley 20 De 2024, Citi Research 25 Nov 2024, Candriam estimates.

higher-rated EM sovereigns do not look expensive any longer versus US IG corporates, while lower-rated EM spreads have lost most of the relative attractiveness they offered at the beginning of 2024.

Spread decompression can occur in an environment of gradual decline of developed market rates, even if the Federal Reserve is expected to cut less aggressively than previously assumed. This should keep EM hard currency bonds attractive relative to other asset classes.

The asymmetries are less attractive in EM credit heading into 2025, with limited upside in more benign outcomes and scope for spread widening if the trade war weighs on global growth. Having said that, at yields of around 7.6% the sovereign market is still attractive and able to bear spread volatility. On an assumption of 10Y US Treasury yields between 4.75%-5.0% and EM spreads between 330 and 360 bps, EMD HC returns are likely to be around 4% - 7% over the next 12 months.

Figure 1:
EMD Return Outlook for 2025
Projected return on JPM EMBIG



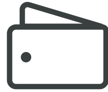
The scenarios presented are an estimate of performance based on evidence from the past on how the value of this investment varies, and/or past and current market conditions and are not an exact indicator. This example is for illustrative and educational purposes only, it is hypothetical in nature, does not reflect actual investment results and is not a guarantee of future results. It is provided as an example only and is not representative of any specific investment or strategy. There is no guarantee that any investment strategy will be successful.

Source: Candriam

Portfolio Positioning.

Given the US administrations' likely objectives, especially on trade, we expect higher long-dated rates and an overall stronger dollar. Therefore we are selective in our EM currency exposure and prefer maturities of less than ten years, especially in countries where USD spread curves are flat. We maintain our negative view on China and are underweight the currency as well as maintaining our large underweight in USD credit strategies.

We favour countries where fiscal discipline is likely to be maintained.



€149 Bn

of assets under management 30 June 2024

600+

experts at your service

+25 years

of innovation and expertise

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